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THE JAPANESE ECONOMY IN 1986

Summary

Overall Japanese growth in 1986 was the lowest recorded since 1974 as the economy struggled to advance under the weight of an appreciated yen. Echoes of the strong yen reverberated in the external sector, where a contraction detracted from growth for three-fourths of the year. Nevertheless, Japan scored another record trade surplus, much to the ire of its trading partners, largely as a result of the so-called J-curve effect. Mirroring this development, capital outflows continued at a torrential rate, triggering a mild backlash as Japanese investors and financial institutions suddenly acquired significant market power. Although Tokyo was buffeted by these developments, some of which were of its own making, officials were hard-pressed to keep the economy growing with their fiscal-policy hands tied.

Overview of GNP Growth

Japan's 1986 total output of final goods and services increased by just 2.5 percent in inflation-adjusted terms, disappointing Tokyo and its trading partners. The performance was a shadow of the previous year's 4.7 percent expansion, and Tokyo pointed to the yen's rise against the dollar as the primary reason for the modest showing. In fact, for the first time in several years, the external sector detracted from economic growth (see Table 1). Nevertheless, the Japanese economy kept pace with its cross-Pacific rival, the United States.

Overall economic output on a quarterly basis revealed the resiliency of the economy. A 3 percent-plus rate of growth in the second, third and fourth

quarters was weakened by a disastrous first-quarter contraction, the first since 1975. A sharp drop in exports combined with weak capital investment and consumer spending accounted for the negative figure.

The growth recession certainly took the Economic Planning Agency by surprise. It was clear that the agency's 4 percent real growth forecast for fiscal 1986 was overly optimistic by the end of calendar 1986. In fact, officials incorrectly forecast the behavior of every major component, an indication of the breadth and depth of the strong yen's impact.

Personal Consumption - Erratic is the only way to describe Japan's household consumption last year. After a weak start in the first quarter, consumers went on a spending binge for the next six months, encouraged by stable or declining prices on domestic and imported goods. As the impact of the yen's rapid appreciation dimmed the business outlook, however, consumers developed cold feet and spending contracted in the last quarter of the year. While this sector's share of GNP was unchanged from the previous year's 55.8 percent, the boom-and-bust pattern did yield slightly better overall growth.

The mixed performance reflected several conflicting factors. While average wages rose 3.5 percent and second incomes also grew, overtime hours declined and disposable income inched up only 1.6 percent. Combined with a 0.6 percent rise in consumer prices, real incomes rose only 1 percent, just half of 1985's gain.

There were no significant changes in spending patterns; the share of monthly outlays for food (the largest expense at over one-fourth of the total), housing, utilities; consumer goods and services remained steady. Underlying this stability was a complex balance. Consumption of fish was down but meat purchases rose, consumers also bought more fruits and vegetables. At the same time, people spent more of their income on eating out, the biggest component of food expenditures in both 1985 and 1986. The cost of education and housing continued to go up, but this was balanced by declines in the costs of most types of energy. While shoppers did benefit somewhat from the yen's appreciation, it was clear that they are reaping only a small percentage of the potential benefits.

Private Residential Construction - This component of GNP put on a surprisingly strong performance in 1986. After recording a strong 6.3 percent annualized growth rate in the first quarter, growth more than doubled in each of the next two periods before falling back. The double-digit gain in 1986 had been seen only once before in the post-OPEC era, when 10 percent growth was recorded in 1978. New housing starts rose 10.4 percent to 1,364,609 units with an average floor space of 81.3 square meters, continuing the trend toward smaller houses (the average size in 1985 was 83.4 square meters). Indicating that home ownership is getting farther out of the reach of the average consumer, the number of rental units rose an impressive 22.5 percent to 645,886, while owner-occupied units grew just 2.7 percent to 477,050 units and units built for sale dropped 1.7 percent to 220,155 units.

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Table 1: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	1985	1986	January-March 1986	April-June 1986	July-September 1986	October-December 1986
Gross National Product	Y291,207.0 (4.7%)	Y298,346.6 (2.5%)	Y294,483.4 (-1.7%)	Y297,230.1 (3.8%)	Y299,438.0 (3.0%)	Y301,619.4 (2.9%)
Personal Consumption Spending	162,103.4 (2.6%)	166,478.9 (2.7%)	164,123.7 (1.6%)	166,134.2 (5.0%)	168,282.5 (5.3%)	167,048.0 (-2.9%)
Private Residential Construction	14,002.1 (2.6%)	15,418.1 (10.1%)	14,340.6 (6.3%)	14,808.5 (13.7%)	15,851.9 (31.3%)	16,625.4 (21.0%)
Private Fixed Nonresidential Investment	52,224.7 (12.3%)	55,578.4 (6.4%)	54,983.4 (1.3%)	55,204.3 (1.6%)	55,471.9 (2.0%)	56,617.8 (8.5%)
Change in Business Inventories	2,273.1 (62.1%)	1,136.5 (-50.0%)	1,726.5 (-60.1%)	639.5 (-98.1%)	920.4 (329.1%)	1,351.4 (364.8%)
Government Current Expenditures	27,072.8 (2.0%)	28,868.3 (6.6%)	27,606.7 (3.5%)	27,719.2 (1.6%)	28,058.0 (5.0%)	32,065.4 (70.6%)
Government Fixed Investment	20,935.6 (-6.6%)	21,858.9 (4.4%)	21,022.4 (1.2%)	21,785.4 (15.3%)	22,180.2 (7.4%)	22,428.9 (4.6%)
Change in Government Inventories	302.2 (*)	808.5 (*)	39.6 (*)	3,251.8 (*)	1,795.1 (*)	-1,866.9 (*)
Net External Sector	12,293.1 (29.8%)	8,198.9 (-33.3%)	10,640.6 (-42.8%)	7,687.2 (-72.8%)	6,878.0 (-35.9%)	7,349.4 (30.4%)
Exports of Goods and Services and Factor Income Received	55,133.4 (5.3%)	52,471.5 (-4.8%)	52,208.9 (-12.4%)	53,044.1 (6.6%)	52,640.0 (-3.0%)	52,127.4 (-3.8%)
Imports of Goods and Services and Factor Income Paid	42,840.3 (-0.1%)	44,272.6 (3.3%)	41,568.3 (-1.6%)	45,356.9 (41.8%)	45,762.0 (3.6%)	44,778.0 (-8.3%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

There seemed to be two sources driving the boom: the increased availability of subsidized loans for home buyers and a reevaluation of loan policies by private lenders. The number of new loans extended by the government Housing Loan Corp. increased by 3.8 percent to 440,000 valued at Y3,154.6 billion ($22.5 billion at Y140=$1.00). The 14.1 percent increase in the loan value stemmed from Tokyo's October 1985 decision to increase HLC funds. Moreover, changes in tax laws and skyrocketing land values encouraged increased activity by private lenders. Lending by mutual savings and loan banks jumped 20 percent in quantity and 15.1 percent in value, while credit association loan volume grew 11.2 percent for a 16.7 percent rise in value. In an interesting twist, financial institutions specializing in housing loans issued 7.3 percent fewer loans, but the value of those loans mushroomed by 72.6 percent. The general rise in housing prices may explain some of this phenomenon, but it is more likely that these companies were targeting the high end of the market.

Private Nonresidential Construction - The expansion of capital investment finally cooled in 1986 to 6.4 percent after 1985's blistering 12.3 percent real increase. This second-largest component of GNP was hammered by the strong yen, as growth in the first nine months of the year registered a weak 2 percent or less in the face of postponed expansion plans. Plant and equipment expenditures finally recovered somewhat in the last quarter as the adjustment process moved into full swing.

As shown in Table 2, the growth of investment by all industries fell to just one-sixth of the previous year's pace. All but four manufacturing industries reduced capital spending, with electric and nonelectric machinery leading the way. Interestingly, investment by the automotive sector advanced, although last year's gain paled in comparison to the huge increase of 1985. The nonmanufacturing sector clearly contributed the lion's share of investment growth, with only three of these 11 industries showing declines. The drop in mining signaled the beginning of the end for this sector; most mining companies have announced very severe cuts in output and employment. On the other hand, the jump in investments by large retailers revealed expectations of greater consumer spending, while greater outlays by transportation and communications industries indicated the positive effects of deregulation. The statistics also showed how unevenly the burden of the stronger yen was distributed: export-oriented areas cut back as overseas revenues fell, while those businesses serving domestic demand continued to spend on new facilities.

Change in Business Inventories - The unusually large swings in this component reflected the difficulties businesses experienced as the appreciating yen soured export markets and then depressed domestic demand. The industrial operating rate drifted down in 1986, averaging 5 percent less in the fourth quarter than in the first three months of the year.

Public Sector - After four years of negligible expansion, government spending made a strong contribution to overall growth in 1986, accounting for 1.1 percentage points of the 2.5 percent increase in real growth. As usual there was a slight bulge in current expenditures in the first quarter due to the adoption of the supplementary budget for FY 1985. But more interesting was the upward trend during the latter half of the year. Tokyo seemed to be responding to the economic slump by loosening its purse strings -- revealing a partial return to Keynesian methods. Fixed investment made its first positive

Table 2: Capital Investment by Sector, FY 1985-FY 1986

(in billions of yen; percent change)

	FY 1985 (Actual)		FY 1986 (Estimated)	
All Industries	Y23,659.8	7.9%	Y23,973.2	1.3%
All Manufacturing	10,672.3	7.9	9,945.2	-6.8
Foods	628.7	7.7	699.7	11.3
Textiles	203.6	3.8	197.5	-3.0
Paper and Pulp	455.9	23.8	424.1	-7.0
Chemicals	1,420.3	10.8	1,350.5	-4.9
Oil and Coal	295.5	7.5	298.9	1.2
Rubber and Leather	175.5	8.9	158.9	-9.5
Glass and Stone Products	447.4	8.5	390.7	-12.7
Steel	833.8	3.0	801.1	-3.9
Nonferrous Metals	320.8	10.6	281.2	-12.3
Metal Products	304.3	8.6	288.6	-5.2
Nonelectric Machinery	569.1	6.2	433.4	-23.8
Electric Machinery	2,372.4	-7.0	2,098.4	-11.5
Transportation Machinery	1,707.6	35.7	1,654.0	-3.1
Cars and Trucks	1,398.5	46.5	1,423.0	1.8
Ships	65.4	17.2	59.1	-9.7
Other	243.7	-1.9	171.9	-29.4
Precision Machinery	324.4	13.4	272.2	-16.1
Printing and Publishing	323.0	2.7	371.7	15.1
Other Manufacturing	290.0	2.7	224.6	-22.6
All Nonmanufacturing	12,987.5	7.9	14,027.9	8.0
Agriculture	34.9	38.2	35.8	2.7
Mining	172.3	-25.7	92.2	-46.5
Construction	278.0	-12.8	313.8	12.9
Wholesaling and Retailing	1,358.0	7.2	1,450.2	6.8
Wholesaling	627.2	3.1	708.2	12.9
Large Retailers	296.1	12.1	330.8	11.7
Other Retailers	434.6	10.1	411.1	-5.4
Finance and Insurance	567.0	-0.8	668.7	17.9
Real Estate	1,151.4	14.4	1,114.8	-3.2
Transportation and Communications	1,584.3	12.6	1,678.8	6.0
Private Railways	351.1	9.4	427.9	21.8
Ground Transportation	444.1	34.2	390.1	-12.2
Shipping	292.5	-8.3	297.6	1.8
Other	496.5	13.7	563.3	13.5
Electric Power	3,072.0	0.9	3,545.2	15.4
Gas	290.8	8.0	322.0	10.7
Services	1,128.6	21.9	959.3	-15.0
Leasing	3,350.3	12.6	3,847.0	14.8

Source: Economic Planning Agency

showing in four years, pointing to the long-term effects of looser fiscal policy. Finally, the huge leap in government inventories in the second quarter was due to the Finance Ministry's massive purchases of gold to mint a commemorative coin. This one-time event had a brief and minimal impact on growth.

Net External Sector - Nowhere was the deflationary effect of the strong yen more clearly shown than in these figures. After years of serving as a major prop for growth, the external sector was a drag on the economy in 1986. The gains of 1985 were completely erased and more as a decline in exports and an increase in imports rocked the economy. Net exports went into a free-fall for the first three quarters before recovering ground in the last period as the value of exports and imports gyrated in response to the volatile yen-dollar exchange rate. All told, the external sector knocked 1.4 points off the overall real GNP growth rate, dropping it from a respectable 3.9 percent to a disappointing 2.5 percent.

While values fluctuated wildly, the volume of trade remained fairly steady. Japan continued to enjoy the benefits of depressed global prices for energy and other commodities while its manufacturers struggled to hold on to foreign market shares. Japan's struggle to retain international industrial competitiveness in the face of the shifting comparative advantage wrought by the appreciating yen is revealed by an analysis of microeconomic factors.

Labor and Inflation

Employment grew 0.8 percent in 1986, a poor showing compared to the 2.6 percent increase in the United States. The role of women in the workplace continued to expand: female employment was up 1 percent, while the increase for males was just 0.7 percent. Unemployment hit a record 2.8 percent, up from 1985's 2.6 percent level; moreover, for four months levels were at a then all-time-high of 2.9 percent. Although only 1.6 percent of men were counted as unemployed, the number of unemployed women continued to edge upward, reaching 1.13 percent as opposed to 1.06 percent in 1985.

The process of change in the labor market that started in the early 1980s as the economy entered the post-industrial phase accelerated under the stress of the yen's appreciation. Cracks in the lifetime employment system began to widen as firms sought to streamline operations and cut unprofitable business lines. The second-tier labor market, which never offered lifetime employment, also showed signs of becoming saturated. The downturn seemed to be so sharp and arrived so quickly that the growth of part-time workers nearly ground to a halt, increasing a bare 0.6 percent compared with 1985's 2.9 percent. Firms did not have time to adjust employment by attrition and found few openings to shift workers to other divisions, subsidiaries or subcontractors. Forced to make do with what they had, most apparently turned away part-time employment seekers.

As manufacturing firms adjusted output, overall productivity rose by a lackluster 2.2 percent, well below 1985's 4.2 percent performance. Only three industries -- lumber and wood products (13.2 percent), pulp and paper (5.6 percent) and electric machinery (4.7 percent) -- showed gains above 3 percent. Productivity in the nonelectric machinery sector actually declined 5.2 percent, while transportation equipment workers eked out a 0.1 percent gain.

For a change, wage increases outpaced productivity gains. Except for the three above-mentioned sectors, pay raises in manufacturing were above (sometimes well above) respective productivity gains. Even so, the 2.4 percent average wage gain fell short of the previous year's 4 percent increase. In effect, almost everyone was worse off: competitiveness was damaged and workers received smaller wage increases.

Inflation continued to be a bright spot in the picture. Domestic wholesale prices actually declined by 4.8 percent, pulled down by a 4.9 percent drop in the cost of manufactured goods, a 4.4 percent cut in the cost of energy, a 1.7 percent reduction in the prices of mining products and a 1.1 percent fall in agricultural prices.

An average 14.5 percent cut in yen export prices reflected Japanese efforts to hold on to foreign markets. Price cuts of 28 percent and 22.7 percent indicated how tough international competition was in the chemical and the metals and metal products markets, respectively. Even in areas of strength, such as electric machinery (a 14.1 percent drop), transport equipment (down 9.8 percent) and nonelectric and precision machinery (off 9.3 percent), Japanese exporters were forced to accept lower prices. On the other side of the coin, however, import prices fell even more sharply, contracting by an average 34.7 percent. Petroleum and natural gas prices were down 43.1 percent, food prices were off 26.6 percent, and the cost of imported machinery and equipment declined 21 percent. The combined effect was a 9.4 percent decline in the overall wholesale price index.

Consumers were also blessed with steady prices as inflation subsided to 0.6 percent, well below 1985's already low 2 percent mark. Prices for meat, fruits, vegetables, energy and particular durable and nondurable goods showed declines. Of those items increasing in price, education (3.6 percent), housing (2.5 percent) and medical care (1.9 percent) led the way by a considerable margin.

Production and Profits

As might be expected, production and profit figures for Japanese manufacturers did not present a pretty picture. After jumping during the 1983-85 expansion, production was down 0.3 percent in 1986. The output of final demand goods rose 0.6 percent, however, as production of investment goods expanded 0.4 percent (an 0.8 percent rise in capital goods outweighed a 0.7 percent drop in construction materials) and consumer goods output increased 0.8 percent (nondurables rose 1.1 percent while durables went up 0.2 percent). On an industry basis, only electric machinery (6 percent), precision equipment (4.6 percent), chemicals (0.4 percent), pulp and paper (2.9 percent) and food products (0.9 percent) showed increases. The sharpest drop in output appeared in the nonelectric machinery industry (7 percent), followed by steel (6 percent).

Because companies use different fiscal years for accounting purposes, the profit picture is always somewhat confused. According to the Ministry of Finance, however, sales by incorporated businesses declined by 0.1 percent in the first three quarters of 1986 over the year-earlier period, resulting in a 5.4 percent drop in profits (see Table 3). The manufacturing sector was particularly hard-hit, as sales plunged 34.8 percent and profits plummeted 24.7 percent. In fact, the only increase in both indicators was in paper and pulp,

where profits rose 32.3 percent on a 3.6 percent increase in sales. Nonmanufacturing industries fared much better. The construction industry recorded a much-needed 39.5 percent increase in profits on a 13.7 percent jump in sales. Interestingly, electric utilities managed to reap a 14.9 percent profit gain despite an 8.2 percent drop in sales. Similarly, gas and water companies' revenues declined (4.7 percent) but profits rose (36.5 percent). A significant portion of the benefits of a strong yen and cheap oil obviously were not passed on to domestic consumers, despite government-mandated rate cuts and rebates.

Table 3: Business Results of Japanese Companies, January-September 1986

(in billions of yen and percent change over year-earlier period)

	Sales		Profits	
Incorporated Firms				
Construction	Y49,810	13.7%	Y1,541	39.5%
Agriculture	2,340	-14.1	75	-25.7
All Manufacturing	146,274	-34.8	7,557	-24.7
Mining	1,661	-32.8	54	-83.1
Textiles	7,409	-2.3	245	-7.5
Steel	10,221	-15.6	108	-80.3
Paper and Pulp	6,150	3.6	348	32.3
Nonferrous Metal Products	5,878	-17.1	156	-15.7
Chemicals	19,835	-13.8	1,322	-9.7
Fabricated Metal Products	10,350	2.3	491	-7.5
Nonelectric Machinery	13,746	-3.0	537	-24.7
Precision Machinery	4,526	-6.2	160	-45.4
Shipbuilding	3,347	-11.6	86	-3.4
Transportation Equipment	25,623	-5.7	584	-50.6
Wholesale Trade	249,771	0.6	2,695	4.9
Retail Trade	51,237	12.5	1,020	4.7
Electric Utilities	9,319	-8.2	2,082	14.9
Gas and Water	1,455	-4.7	172	36.5
Real Estate	13,130	23.6	1,639	47.4
Transportation and Communications	27,122	4.0	1,942	10.3
Services	30,052	10.7	1,495	-0.8
All Industries	642,172	-0.1	20,273	-5.4
Unincorporated Firms				
Manufacturing	12,752	-9.9	4,218	-13.7
Wholesale and Retail	16,637	-7.3	11,220	-7.2
Services	5,565	7.5	1,078	24.5

Source: Ministry of Finance

Monetary Policy

All semblance of a steady monetary policy was dropped in 1986 as the Bank of Japan lowered the official discount rate by 0.5 percentage point four times -- January 29, March 7, April 7 and October 31. This left the most basic lending rate at an all-time-low 3 percent at the end of the year. Commercial loan and savings rates were also reduced (see Table 4). The basic reason for these cuts was to stabilize the volatile yen-dollar exchange rate and counteract the negative effects of a stronger yen. However, the three cuts in 1986's first four months accomplished little. In fact, they may have added to the perception of volatility. The yen continued to rise steadily until it hit a high of Y152.55 to the dollar on August 20 before falling back to the Y160 level for the remainder of the year.

Table 4: Japanese Interest Rates, 1986

(in percent per annum)

	January 1, 1986	December 31, 1986
Postal Savings System		
Ordinary Savings	2.88%	1.68%
Installment Savings	3.72	2.64
Fixed Amount Savings		
Six months or more	4.00	2.26
One year or more	4.50	2.76
One-and-a-half years or more	5.25	3.51
Two years or more	5.50	3.86
Two and one-half to three years	5.65	3.91
Three years or more	5.75	4.01
Ten years or more	n.a.	4.87
Time Deposit Savings		
Six months	4.75	3.01
One year	5.50	3.76
Commercial Savings Rates		
Time Deposit		
Three months	3.50	1.76
Six months	4.75	3.01
One year	5.50	3.76
Two years	5.75	4.01
Installment Savings	3.40	2.28
Deposits for Tax Payments	2.25	1.01
Ordinary Deposits	1.50	0.26
Notice Deposits	1.75	0.51
Special and Other Deposits	1.50	0.26

Source: Bank of Japan

Money Supply - This item (M2 + CDs, average outstanding amount) rose 8.7 percent, only slightly higher than the 8.4 percent mark of the previous year. In late 1985 and early 1986 Bank of Japan officials were concerned that monetary growth was getting out of hand since expansion rates of 9 percent were recorded for the last quarter of 1985 and the first quarter of 1986. There was some relief as the rate fell below 9 percent for the remainder of 1986, although it still outstripped the pace of real economic growth, raising fears of renewed inflation. These fears turned out to be premature as consumer prices edged up and producer prices actually declined.

The absence of stagflation was perplexing since the expansion of most domestic demand components was equal to or below the previous year's (except for housing construction). A breakdown of money supply growth by source sheds some light. While currency in circulation expanded at a heated 11.9 percent pace (more than double the previous year's 5.8 percent level), deposits (9.8 percent) and quasi-money (8.8 percent) also grew quickly. Since cash represents only about 8 percent of the money supply, much of the increased money supply was not spent on goods. Deposits by businesses grew 11.2 percent (compared to 0.3 percent growth in 1985), a trend echoed by individual deposits, which rose 10.6 percent versus 5.6 percent. The hectic expansion of quasi-money (such as money market certificates) slowed in 1986, falling from 11.5 percent; corporations and individuals upped their holdings by 12.2 percent and 6.8 percent compared with 1985 growth rates of 17 percent and 7.8 percent, respectively. Finally, certificates of deposit also grew at a faster rate -- 5.5 percent versus 2.9 percent.

Financial Deregulation - Spurring this movement into non-cash holdings was the Finance Ministry's continuing program of financial deregulation:

- Deregulation of interest rates on deposits took two steps in 1986. On April 1 MOF lowered the minimum size of large time deposits that offer non-regulated rates of interest from Y1 billion ($7.1 million) to Y500 million ($3.6 million). This floor was lowered again on September 1 to Y300 million ($2.1 million). Maturities were unchanged at 3 to 24 months.

- MOF also permitted banks to expand offerings of money market certificates and certificates of deposit. On April 1 banks were allowed to issue instruments worth up to 200 percent of shareholders' equity, a one-third increase. This ceiling was raised again on September 11 to 250 percent. At the same time, the maximum maturity for MMCs and CDs was increased from 6 months to 12 months at the start of fiscal 1986. While the minimum size of a CD remained fixed at Y100 million ($714,286), the minimum size for MMCs was lowered from Y50 million ($357,143) to Y30 million ($214,286) on September 11.

- The Tokyo International Banking Facility opened its doors December 1 with much official fanfare but lukewarm commercial interest. After almost a year of planning and discussion, the Tokyo offshore market emerged with more regulations and limitations than its New York or London counterparts. Funds attracted to Tokyo offshore accounts cannot flow into domestic accounts nor can they be used to issue domestic CDs or purchase domestic bonds. In contrast, the London market has no such barriers and the New York market only requires that certain reserve rates be maintained. While all three facilities exempt accounts from withholding taxes, domestic reserve requirements and domestic

interest rate regulations, Tokyo accounts still face local and stamp taxes. Nevertheless, the facility grew quickly from its opening day volume of $51 billion to $93 billion by the end of the month and well over the $100 billion mark by the end of January 1987. In short, despite the restrictions (which may eventually be removed), the Tokyo IBF performed very nicely.

- MOF began a campaign to reinvigorate domestic bond markets after its successful deregulation of overseas yen-denominated markets. It urged major Japanese securities firms to begin quoting prices for samurai bonds (yen-denominated bonds issued by a foreign government or international agency) on a daily basis and sought to build a secondary market for the securities to enhance their attraction. Requirements for issuers of samurai and shogun (like samurai bonds but denominated in foreign currencies) bonds were also reduced. MOF considered lowering the requirements for issuing unsecured and convertible bonds to entice more domestic firms to raise money at home. Rules governing secondary sales of bonds and the timing of bond sales were also eased.

MOF also took several steps to prepare Japanese financial institutions for the rigors of global competition:

- New standards for financial ratios were drafted at the start of fiscal 1986. Banks were warned that they must increase their equity to bring their net-worth-to-total-asset ratio to 4 percent -- a much tougher requirement than the previous net-worth-to-deposit ratio of 10 percent. Accounting methods for loan guarantees and loans to subsidiaries were also tightened in response to the Sankyo Steamship Co., Ltd. bankruptcy, which threatened to pull down several of the shipping company's creditor banks.

- The Bank of Japan replaced the three-tiered system of reserve requirements on June 28 with a more complicated method. Although Japanese banks are now grouped into five different categories based on total assets and required to keep varying percentages of time and other deposit assets with the BOJ in interest-free accounts, the overall effect was to lower reserve requirements and increase flexibility.

- The Investment Advisory Act went into effect November 26 in response to a number of scandals. Investment consultants must now provide the Finance Ministry with proof of their financial and business standings to qualify for a basic license. Stricter requirements also apply to a discretionary license, which allows a firm to take actions without first getting the client's approval, although most major domestic and many foreign firms qualify with ease.

In addition, MOF began preparations to regulate the mortgage-backed securities market, which has suffered from fraud and failures. Although the strength of the real estate market has yielded huge returns to some investors, it also allowed unscrupulous operators to remain in business. The government's scrutiny signals the end of free-wheeling deals in this rapidly growing market.

Beside the offshore market, MOF opened other doors to foreign firms. The most significant was an unofficial policy allowing bank-affiliated companies to trade in securities. Citicorp, American Express Bank Ltd., Swiss Banking Corp., Baring Brothers and Dresdner Bank of West Germany were all allowed to open new brokerage subsidiaries or convert existing units into securities firms. The groundwork for expanding the Tokyo Stock Exchange and giving

foreign firms a greater role in the Japanese government bond market was also laid in 1986.

Balance of Payments - Despite record trade ($92.8 billion) and current account ($85.9 billion) surpluses, Japan's overall balance of payments deficit nearly quadrupled to $44.8 billion from 1985's $12.3 billion mark. The outflow of long-term capital more than doubled to $131.5 billion and the short-term capital balance also remained in the red at $1.6 billion, easily swamping the impact of the trade surplus. The capital outflow reached such proportions that Tokyo became concerned over the impact on domestic investment. Moreover, a backlash began to develop against the surge of Japanese investments in foreign markets. It was clear that national financial markets were becoming inextricably linked.

Exchange Rates - In a stunning example of these links, the Group of Seven Western industrial nations continued their coordinated program to lower the value of the dollar against the yen and West German mark that began in September 1985. Japan, West Germany and the United States simultaneously lowered their discount rates in March 1986 to encourage the orderly rise of the yen and mark. The yen began the year at an average monthly rate of Y200.05 (as traded on the Tokyo interbank spot market), and rose to Y154.11 in August before falling back to Y162.13 in December. The December-to-December rise of 25 percent topped 1985's gain, straining Japan's export industries and putting fiscal policy on the spot.

Fiscal Policy

Despite the flagging economy, fiscal policy remained handcuffed in 1986. The initial fiscal 1986 general account budget did not increase discretionary spending. An 8 percent increase in debt service and transfers to local governments resulted in a 3 percent rise in overall spending. The fiscal reconstruction program of Prime Minister Yasuhiro Nakasone and the Ministry of Finance remained in force, favoring national defense (6.6 percent) and foreign economic cooperation (6.3 percent) while reducing food price supports (-14.3 percent), education (-0.3 percent) and public works (-2.3 percent).

On the tax side, the news for business was also bad. In order to pay for more generous home-loan regulations and some minor improvements in depreciation allowances, over Y260 billion ($1.9 billion) worth of tax deductions or credits were eliminated. The suspension of the carryover of losses was particularly painful given existing business conditions. In part because of an increase in tobacco excise taxes, tax and stamp revenues were projected to increase by Y2 trillion ($14.3 billion).

The growth of the Fiscal Investment and Loan program, a self-funding second budget, was positive in FY 1986, with a 6.2 percent increase slated. Spending hikes of 10 percent-plus were planned in housing, water works, roads, transportation and communications, and regional development programs. It was clear that FILP expenditures were boosted in an attempt to counteract the deflationary effects of no growth in discretionary general account outlays.

Even as late as the end of 1986, fiscal austerity remained in vogue. The supplementary budget for FY 1986 actually cut overall expenditures by Y263.8 billion ($1.9 billion). This was slightly misleading, however, as the

emphasis was on increased public works spending and government employee wage hikes, while reductions took the form of savings generated by lower oil prices and the stronger yen. Nevertheless, the overall figures held little promise of immediate stimulus. Neither did the reflationary packages announced by the government in April and September. The reliance on the private sector and the long-term emphasis of the packages nullified any immediate impact they might have had.

In spite of this fiscal quiescence, foundations for important policy changes were being laid. Of greatest note were preparations for the most wide-ranging tax reform program in over two decades. The general outline was set by the end of the year and included reductions in personal and corporate income tax rates, a restructuring of personal income tax brackets, elimination of the popular tax-exempt small savings accounts, changes in commodity and excise taxes, and stronger enforcement. The proposal was highly controversial, particularly the idea of a 5 percent value-added tax, because the prime minister had promised during the 1986 lower house election campaign not to institute a large-scale indirect tax. The tax issue would take on major political dimensions in 1987.

Also of great importance were preparations to privatize the biggest government-owned corporation: Japanese National Railways. The size of JNR's assets, debts and employment presented a Herculean task for administrative reformers. Encouraged by the success of two previously privatized public corporations, Nippon Telegraph and Telephone Corp. and Japan Tobacco Inc., plans were laid to split JNR into several regional passenger rail companies, a cargo company, a holding company and two non-rail operating firms.

Conclusion

Tokyo's efforts to get the economy back on a steady growth track were derailed in 1986 as the strong yen proved a major obstacle. Hampered by its adherence to fiscal austerity, Tokyo was slow to respond. Monetary policy alone was available to deal with both the economic recession and the yen-dollar exchange rate, yet it is almost an axiom that the number of tools required must at least equal the number of problems to solve. Signs of a looser fiscal policy, continued deregulation and liberalization, and steady monetary growth pointed to a more promising situation in 1987, however.

In 1986 Tokyo as well as other capitals became increasingly aware of the depth and strength of economic links between nations, as independent national economic policies grew less and less effective at solving domestic and international economic problems. The need to coordinate and cooperate was vividly brought home by the wild gyrations of the yen-dollar exchange rate. Adjusting to the new economic realities and the challenges they represent will be a difficult process for all governments.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.